

Worksheet Solutions

The Difference Between Tax Avoidance and Tax Evasion

Theme 1: Your Role as a Taxpayer Lesson 3: The Taxpayer's Responsibilities

Key Terms

tax avoidance—An action taken to lessen tax liability and maximize after-tax income.

tax evasion—The failure to pay or a deliberate underpayment of taxes.

underground economy—Money-making activities that people don't report to the government, including both illegal and legal activities.

voluntary compliance—A system of compliance that relies on individual citizens to report their income freely and voluntarily, calculate their tax liability correctly, and file a tax return on time.

Summary

The U.S. income tax system is based on the idea of **voluntary compliance**. Under this system, it is the taxpayer's responsibility to report all income. **Tax evasion** is illegal. One way that people try to evade paying taxes is by failing to report all or some of their income. Sometimes people do not report income gained through illegal activities such as gambling and selling stolen goods. Other times they do not report all the tips they collect or the money they earn through legal activities such as garage sales, baby-sitting, tutoring, or yard work. Such money-making activities are part of the **underground economy**, which exists as a way to avoid paying taxes. If taxpayers fail to pay what officials say they owe, the IRS can assess a penalty, in addition to collecting the back taxes.

In contrast, **tax avoidance** is perfectly legal. IRS regulations allow eligible taxpayers to claim certain deductions, credits, and adjustments to income. For instance, some homeowners can claim a deduction for interest they pay on a home mortgage. Working parents may be able to claim a credit for child-care expenses. There are also deductions based on the number of family members. These are only a few of the many ways people can legally limit the tax they pay. However, the taxpayer must be able to prove that he or she qualifies. Many people pay more federal income tax than necessary because they misunderstand tax laws and fail to keep good records.

Activity 1

Circle each example of tax evasion.

- A. keeping a tip log
 - B. mailing tax forms on time
 - C. ignoring earnings for pet-sitting
 - D. keeping accurate and organized records
 - E. not reporting interest earned on loans
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- C. **ignoring earnings for pet-sitting**
 - E. **not reporting interest earned on loans**

Activity 2

Read the example below and answer the question in the space provided.

Last year Dave and Marie paid more taxes than they owed. After they filed their tax return, they received a refund for overpayment of taxes. This year, Dave and Marie claimed a deduction for interest paid on their home mortgage and claimed a credit for childcare expenses in order to avoid overpayment of taxes. Is this an instance of tax evasion or tax avoidance? Explain why.

Tax avoidance; Dave and Marie are not trying to pay less than they owe. They are trying to avoid overpayment by keeping more detailed records.

Activity 3

Read the example below and answer the question in the space provided.

Suppose that you and your best friend both work in a restaurant. Tips make up a large part of your earnings. You report all the tips you receive and are surprised to learn that your friend does not. Write a persuasive letter to your friend, explaining why he or she should report all tips and how the taxes from these tips fund public services.

Students' letters will vary but should mention the system of voluntary compliance and the importance of each person paying a fair share of taxes. Students also may raise the issue of possible penalties for underreporting income and the distinction between tax avoidance and tax evasion.